RECORD
AND
BRIEFS

No. 14-1458

In the

# Supreme Court of the United States

MHN GOVERNMENT SERVICES, INC., et al.,

*Petitioners,*

v.

THOMAS ZABOROWSKI, et al.,

*Respondents.*

**On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit**

## BRIEF AMICUS CURIAE OF PACIFIC LEGAL FOUNDATION IN SUPPORT OF PETITIONERS

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## QUESTION PRESENTED

The Federal Arbitration Act ("FAA") provides that an arbitration agreement shall be enforced "save upon such grounds as exist at law or in equity for the revocation of any contract," 9 U.S.C. § 2. California law applies one rule of contract severability to contracts in general, and a separate rule of contract severability to agreements to arbitrate. The arbitration-only rule disfavors arbitration and applies even when the agreement contains an express severability clause. Its application in this case conflicts with binding precedent of this Court and with opinions of four other courts of appeals.

The question presented is whether California's arbitration-only severability rule is preempted by the FAA.

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## INTEREST OF AMICUS CURIAE

Pursuant to Supreme Court Rule 37, Pacific Legal Foundation respectfully submits this brief amicus curiae in support of Petitioner, MHN Government Services, Inc.[1] Founded in 1973, Pacific Legal Foundation (PLF) is widely recognized as the most experienced nonprofit legal foundation of its kind. PLF's Free Enterprise Project defends the freedom of contract, including the right of parties to agree by contract to the process for resolving disputes that might arise between them. To that end, PLF has participated as amicus curiae in many important cases in this Court, the California courts and many other state supreme courts involving the Federal Arbitration Act (FAA) and contractual arbitration in general. *See, e.g.*, *DIRECTV v. Imburgia*, No. 14-462 (pending); *Oxford Health Plans LLC v. Sutter*, 133 S. Ct. 2064 (2013); *AT&T Mobility v. Concepcion*, 131 S. Ct. 1740 (2011); *Rent-A-Center, W., Inc. v. Jackson*, 561 U.S. 63 (2010); *Stolt-Nielsen S. A. v. AnimalFeeds Int'l Corp.*, 559 U.S. 662 (2010); *Hall Street Assocs., L.L.C. v. Mattel, Inc.*, 552 U.S. 576 (2008); *Preston v. Ferrer*, 552 U.S. 346 (2008); *Sanchez v. Valencia Holding Co.*, Cal. Supreme Ct. docket no. S199119; *Iskanian v. CLS*

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[1] Pursuant to this Court's Rule 37.2(a), all parties have consented to the filing of this brief. Counsel of record for all parties received notice at least 10 days prior to the due date of the Amicus Curiae's intention to file this brief. Letters evidencing such consent have been filed with the Clerk of the Court.

Pursuant to Rule 37.6, Amicus Curiae affirms that no counsel for any party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than Amicus Curiae, its members, or its counsel made a monetary contribution to its preparation or submission.

*Transportation*, 59 Cal. 4th 348 (2014), *cert. denied*, 135 S. Ct. 1155 (2015); *Gentry v. Superior Court (Circuit City Stores, Inc.)*, 42 Cal. 4th 443 (2007).

## INTRODUCTION AND SUMMARY OF REASONS WHY THE PETITION SHOULD BE GRANTED

MHN Government Services, Inc. is a private company that runs a healthcare-consulting business and employs graduate-school-educated healthcare workers. Pet. App. 12a-13a. The employees claim they were misclassified as independent contractors rather than employees, and that they were consequently deprived of overtime pay in violation of federal and state laws. Pet. App. 13a. Despite their employment contracts' arbitration agreement, a putative class of employees sued the company in federal court. MHN moved to compel the workers to resolve their claims in arbitration. *Id.* The employees argued that multiple provisions of the agreement were unconscionable. The district court agreed with them as to five discrete provisions ancillary to the basic underlying agreement to arbitrate: a shortened 6-month limitations period; waiver of punitive damages; a $2600 filing fee; a fee-shifting clause that awards attorneys' fees to the prevailing party; and an arbitrator-selection clause that allowed the employer to unilaterally choose a pool of three arbitrators from which the employee could then select its choice of arbitrator. Pet. App. 20a-28a. Under the California Supreme Court decision in *Armendariz v. Found. Health Psychcare Svcs., Inc.*, 24 Cal. 4th 83, 124 (2000), if a court finds "more than one unlawful provision" in an arbitration agreement to be unconscionable, it will deny severance and refuse to enforce the agreement in its entirety. Applying this

principle, the Ninth Circuit Court of Appeals declined to sever the offensive provisions, and instead invalidated the entire agreement. Pet. App. 5a.

In the general contractual context, a court applying California law can withhold severance only if it finds, after a fact-intensive provision-by-provision analysis, that the unconscionable provisions truly permeate and infect the entirety of the contract. The court below applied the *Armendariz* severance rule: that a court should refuse to sever unconscionable provisions in an arbitration agreement, whether or not the offensive provisions permeate and infect the entirety of the contract. In so doing, it applies severance doctrine contrary to state statutes that permit severance of multiple discrete provisions, and disfavors arbitration agreements by facilitating invalidation of entire arbitration agreements. In *AT&T Mobility, LLC v. Concepcion*, 131 S. Ct. at 1747, this Court held that the FAA preempts state-law rules that treat arbitration agreements less favorably than other contracts, or even have a "disproportionate impact on arbitration agreements." Judge Gould correctly would have held the *Armendariz* severance rule preempted by the FAA under *Concepcion*, severed the offensive provisions, and held the parties to their contractual agreement to arbitrate. Pet. App. 8a, 11a.

The split decision below highlights the critical question of whether *Armendariz* was abrogated by the this Court's decision in *Concepcion*. *Armendariz*'s approach to severability of provisions in arbitration contracts is uniquely adverse compared to general state contract law of severability, in violation of the federal substantive law of arbitration and the Federal Arbitration Act, both of which require that arbitration

contracts be considered on an equal footing to all other contracts. By refusing to sever invalid provisions in favor of striking down arbitration contracts in their entirety, the Ninth Circuit, applying California law, defeats parties' legitimate expectations of arbitral resolution of disputes, thus harming the rule of law. For the reasons set forth below, the petition should be granted.

## REASONS FOR GRANTING THE PETITION

### I

### THE *ARMENDARIZ* "NO-MORE-THAN-ONE" SEVERABILITY RULE DISFAVORS ARBITRATION CONTRACTS

California's general rule of contract law governing severability is that an invalid provision will be severed unless the invalidity "permeates" the entire contract, rendering it unlawful. Cal. Civ. Code § 1670.5 ("If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result."); Cal. Civ. Code § 1599 ("Where a contract has several distinct objects, of which one at least is lawful, and one at least is unlawful, in whole or in part, the contract is void as to the latter and valid as to the rest."). *See also Birbrower, Montalbano, Condon & Frank v. Superior Court*, 17 Cal. 4th 119, 137 (1998) (relying on Section 1599 to sever invalid portions of lawyers' fee

agreement). In *Dotson v. Amgen, Inc.*, 181 Cal. App. 4th 975, 986 (2010), the California Court of Appeal held that "[a]lthough 'the statutes appear to give a trial court discretion as to whether to sever or restrict the unconscionable provision or whether to refuse to enforce the entire agreement[,] . . . it also appears to contemplate the latter course only when an agreement is '*permeated' by unconscionability*.'" (Emphasis added; citations omitted).

These statutes have been applied in such a way to invalidate the entirety of many arbitration contracts, however, instead of just the offending provisions. So long as an arbitration contract contains only a single unconscionable provision, California courts sever the offending provision and uphold the rest of the contract. But *Armendariz* established the rule that if more than one of these otherwise severable provisions exist in a single contract, unconscionability is deemed to permeate the agreement, rendering it fully invalid and unenforceable. 24 Cal. 4th at 124, cited in Pet. App. at 5a. The *Armendariz* court voiced the concern that it is not for the court to write the contract over for the parties. 24 Cal. 4th at 125. But "[p]artial enforcement [of a contract term] involves much less of a variation from the effects intended by the parties than total non-enforcement would." Arthur L. Corbin, *A Comment on* Beit v. Beit, 23 Conn. B.J. 43, 50 (1949), quoted in Omri Ben-Shahar, *Fixing Unfair Contracts*, 63 Stan. L. Rev. 869, 893 (2011). Disregarding this policy, the *Armendariz* bright-line no-more-than-one rule stands as an obstacle to normal rules governing severance of invalid contract terms.

The key to *Armendariz*'s rule is its presumption that more than one invalid provision "permeates" an

arbitration contract. The "permeated" language is important, because it distinguishes between invalid provisions that can be lined out without altering the basic agreement between the parties and invalid provisions that infect every essential provision, such that lining them out fundamentally alters the contract. Yet none of the California arbitration cases actually define "permeate." However, in different contexts, courts have defined the term to mean "to be diffused throughout," *People v. Bautista*, 115 Cal. App. 4th 229, 236 n.4 (2004), and "cannot be discretely separate from . . . the whole." *In re Grand Jury Subpoena (Mark Torf/Torf Environmental Management)*, 357 F.3d 900, 910 (9th Cir. 2004). These courts recognize that permeation does not depend on the size or quantity of the offending elements, but rather on the extent to which they affect every other aspect of the whole.

The *Armendariz* decision reflects the court's hostility to arbitration by presuming that more than one unconscionable provision *per se* permeates the entire agreement, requiring that the agreement be invalidated in its entirety. 24 Cal. 4th at 124. The no-more-than-one rule, while permitting severance of a single, discrete invalid provision, offers no logical justification (beyond the presumption of permeation) for refusing to sever two, three, or more provisions, if the subject matter of those provisions are also sufficiently discrete from the primary subject of the contract. *See Spinetti v. Service Corp. Intern.*, 324 F.3d 212, 214 (3d Cir. 2003) (severing multiple provisions to uphold an arbitration contract, noting "You don't cut down the trunk of a tree because some of its branches are sickly.").

As the law of arbitration has evolved, many types of provisions have been held unconscionable and severed, so long as no more than one provision is unconscionable. For example, an attorneys' fee shifting provision was held unconscionable and severed from the contract. *See, e.g., Serpa v. California Surety Investigations, Inc.*, 215 Cal. App. 4th 695, 710 (2013) (offending attorney fee provision severed as "plainly collateral to the main purpose of the contract" and remainder of arbitration agreement enforced). Costs provisions have been held unconscionable and severed from the contract. *See, e.g., Gutierrez v. Autowest, Inc.*, 114 Cal. App. 4th 77, 92 (2003) (severing costs provision and enforcing the balance of the arbitration agreement; the central purpose of the contract "was not to regulate costs, but to provide a mechanism to resolve disputes [and] [b]ecause the costs provision is collateral to that purpose, severance was available."). Unilateral appeal provisions have been held unconscionable and severed from the contract. *See, e.g., Little v. Auto Steigler, Inc.*, 29 Cal. 4th 1064, 1075-76 (2003). A provision limiting discovery may be held unconscionable and severed from an otherwise valid arbitration contract. *See, e.g., Dotson*, 181 Cal. App. 4th at 985. There is no logical reason why each of these provisions is described as discrete and collateral to the main objective of the contract in isolation, but the same provisions are suddenly deemed to permeate every aspect of a contract in combination.

Not all federal courts, applying California law, uncritically accept the *Armendariz* no-more-the-one rule. Several district court decisions assess whether the unconscionable provisions are, in fact, central to the arbitration contract and permeate all facets. If discrete provisions can be severed without harming the

parties' general intent to resolve disputes in arbitration, the courts sever those provisions. For example, in *Lucas v. Gund*, 450 F. Supp. 2d 1125, 1134 (C.D. Cal. 2006), the district court cited *Armendariz* but relied on the language of Cal. Civil Code § 1670.5 to sever two discrete, unconscionable provisions (one involving costs and fees; the other mandating New Jersey as the location for the arbitration).[2] Similarly, a district court severed three provisions—relating to carve-outs for injunctive and equitable relief, confidentiality, and attorneys' fees—and upheld an otherwise valid arbitration agreement. *Grabowski v. Robinson*, 817 F. Supp. 2d 1159, 1179 (S.D. Cal. 2011) (arbitration agreement was not "permeated by unconscionability," notwithstanding the three discrete, unconscionable provisions). *See also Hwang v. J.P Morgan Chase Bank, N.A.*, No. CV 11-10782 PSG (JEMx), 2012 WL 3862338 (C.D. Cal. Aug. 16, 2012) (severed invalid fee-sharing and modification provisions because they were "collateral to the agreements" and "would not amount to rewriting the agreements."); *Bencharsky v. Cottman Transmission Systems, LLC*, 625 F. Supp. 2d 872, 883 (N.D. Cal. 2008) (severing multiple provisions limiting the statute

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[2] One California Court of Appeal decision, issued just six months after *Armendariz*, before the anti-arbitration severance rule was firmly established, focused on the severance statute and never mentioned the *Armendariz* no-more-than-one rule. In *Bolter v. Superior Court*, 87 Cal. App. 4th 900, 910-11 (2001), the court severed three unconscionable provisions from an arbitration contract related to a franchise agreement (prohibiting consolidation, limiting damages, and mandating Utah as the forum), finding no reason "to throw the baby out with the bath water" because "[u]nconscionability can be cured by striking those provisions, leaving an otherwise valid and complete agreement to submit disputes to arbitration. *Id.*

of limitations, barring punitive damages, and awarding equitable relief to only one party, while upholding the remainder of the arbitration agreement). These cases demonstrate an ongoing conflict between those California and federal cases that rely on *Armendariz*'s no-more-than-one severance rule, and those that place greater reliance on the language of the California statutes that authorize severance.

This Court's review of this case will impact several cases currently pending in the California courts. For example, in *Trabert v. Consumer Portfolio Services, Inc.*, 234 Cal. App. 4th 1154, 184 Cal. Rptr. 3d 596, 598 (2015), the California Court of Appeal held that unconscionable provisions in an arbitration contract *could* be severed "without affecting the core purpose and intent" of the agreement, thereby promoting "the fundamental attributes of arbitration, including speed, efficiency, and lower costs." However, the California Supreme Court granted the plaintiff's petition for review, 2015 WL 3623587 (Cal. Jun. 10, 2015), vacating the lower court decision and rendering it non-citeable in California courts. Cal. R. Ct. 8.1115; *McMahon v. City of Los Angeles*, 172 Cal. App. 4th 1324, 1336 n.10 (2009). Briefing is deferred pending resolution of *Sanchez v. Valencia Holding Co.*, Cal. Supreme Ct. docket no. S199119. *See also Park v. CTBC Bank Corp.*, No. B255809, 2015 WL 799541, *11 (Cal. Ct. App. Feb. 25, 2015) (unpublished) (invalidating an entire contract because it contained two unlawful provisions, a carve-out provision and a Private Attorney General Act claim waiver).

*Armendariz*'s no-more-than-one severability rule has been in place for 15 years, resulting in invalidation of countless otherwise valid arbitration contracts. The

issue has generated the conflicts among the federal Circuits described in the petition in this case, as well as the differing approaches between California state courts and federal district courts within California. This Court should grant the petition to address this doctrine that undermines the freedom to contract for arbitral resolution of disputes.

## II

## CALIFORNIA'S DEFIANCE OF FEDERAL ARBITRATION LAW INFECTS CONTRACTS NATIONWIDE AND UNDERMINES THE RULE OF LAW

Although, as noted above, federal district courts in California are sometimes willing to apply the Federal Arbitration Act and federal substantive law of arbitration over contrary California caselaw, the Ninth Circuit has too frequently shown itself a willing propagator of California's anti-arbitration doctrines. *See, e.g.*, *Concepcion*, 131 S. Ct. at 1753 (reversing Ninth Circuit application of California's *Discover Bank* anti-class action waiver rule); *Davis v. O'Melveny & Myers*, 485 F.3d 1066, 1082 (9th Cir. 2007) (applying California's *Broughton-Cruz* doctrine, which forbids arbitration of claims seeking public injunctive relief).[3] The Ninth Circuit applies California anti-arbitration doctrine even as it has forthrightly acknowledged that

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[3] The Ninth Circuit subsequently acknowledged that *Concepcion* marked the end of the *Broughton-Cruz* doctrine. *Ferguson v. Corinthian Colleges, Inc.*, 733 F.3d 928, 933-34 (9th Cir. 2013) (holding that *Concepcion* overruled *Davis*). The California Supreme Court has not yet made the same acknowledgment. *But see McGill v. Citibank*, 232 Cal. App. 4th 753 (2014), *review granted*, 185 Cal. Rptr. 3d 430 (2015) (question presented whether *Broughton-Cruz* survives *Concepcion*).

California law disfavors arbitration contracts, as compared to the law of other states. *See Bridge Fund Capital Corp. v. Fastbucks Franchise Corp.*, 622 F.3d 996, 1003-05 (9th Cir. 2010) (citing *Carter v. Countrywide Credit Indus., Inc.*, 362 F.3d 294, 301 n.5 (5th Cir. 2004) (noting that California law is more hostile than Texas law to arbitration agreements, and the application of one law instead of the other is often determinative on the question of the enforceability of the agreement and then applying California law to determine that the arbitration contract was unconscionable).

The problem is not limited to California and the Ninth Circuit. California's hostility to arbitration has considerable potential to influence other states. As a center of economic trade, contracts across the country often provide that California law controls. *See, e.g., Triad Sys. Fin. Corp. v. Stewart's Auto Supply, Inc.*, 47 F. Supp. 2d 1332, 1334 (N.D. Ala. 1999) (Alabama residents bound by contract that made California law controlling); *Sec. Ins. Co. of Hartford v. TIG Ins. Co.*, 360 F.3d 322, 323 (2d Cir. 2004) (upholding reinsurance agreement that designated California law as controlling); *Naegele v. Albers*, 940 F. Supp. 2d 1, 8-9 (D.D.C. 2013) (relying on California arbitration law and staying federal proceedings); *Bragg v. Linden Research, Inc.*, 487 F. Supp. 2d 593, 605 (E.D. Penn. 2007) (applying California unconscionability law, particularly *Armendariz*, to strike down an arbitration agreement); *Phillips Petroleum Co. v. Arco Alaska, Inc.*, No. 7177, 1986 WL 7612, at *6-7 (Del. Ch. July 9, 1986) (parties to oil and gas leases in Prudhoe Bay, Alaska, agreed that California law controlled their arbitration contract).

The Supreme Court of the Territory of Guam, in *Pangelinan v. Camacho*, 2008 Guam 4, 2008 WL 686242, relied on *Armendariz*'s presumption of permeation to invalidate an entire 281-page contract because of a single unconscionable provision. Presiding Justice Pro Tempore Benson, concurring and dissenting, expressly noted the conflict between the *Armendariz* approach, expansively adopted by the majority opinion, and *Gannon v. Circuit City Stores, Inc.*, 262 F.3d 677, 681-82 (8th Cir. 2001), which severed a similar, unconscionable damages clause to preserve the rest of the contract. *See also* Pet. at 20-21 (describing *Gannon* and other courts in conflict with *Armendariz*'s restrictive severance rule).

This Court should address the consequences of California's widespread defiance, enabled and expanded by the Ninth Circuit. "[S]tate judicial noncompliance sanctions lawlessness. Defiance of this breed undermines the rule of law and reduces faith in the legal order, which could lead to more general kinds of illegality." Salvatore U. Bonaccorso, Note, *State Court Resistance to Federal Arbitration Law*, 67 Stan. L. Rev. 1145, 1169 (2015). If this Court does not rein in California's obstinate disregard of federal law, the federal substantive law of arbitration, as well as the Federal Arbitration Act, will suffer drastic changes from one state to the next. When some states comply with the Court's rulings, and others do not, the people ostensibly governed by the law cannot reliably predict judicial outcomes, an especially critical concern in contract interpretation. Bonaccorso, *supra*, at 1170. This then hampers one of the law's main purposes—to influence people's future behavior. *See Church of Scientology of California v. IRS*, 792 F.2d 153, 155 n.1 (D.C. Cir. 1986) (secondary appellate review is best

reserved for "the establishment of legal rules for future guidance"), *aff'd*, 484 U.S. 9 (1987). Moreover, the cost to defend the enforceability of an arbitration agreement in a court hostile to arbitration discourages the use of arbitration, contrary to the purpose of the Federal Arbitration Act. *See* Imre S. Szalai, *Modern Arbitration Values and the First World War*, 49 Am. J. Legal Hist. 355, 355 (2007).

## CONCLUSION

The petition for a writ of certiorari should be granted.

DATED: July, 2015.

Respectfully submitted,

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